Information from the Division of Health Care Finance and Policy

FY04 Annual Acute Hospital Financial Report

Overall profitability improved for the hospital industry in FY04. The majority of hospitals reported healthier operating performance and fewer hospitals operated at a loss. Profitability was further enhanced by improved non-operating performance. Owing to overall improvements in profitability and revenue cycle management, the majority of hospitals demonstrated improved cash flow and more comfortably met short-term obligations. In addition, solvency improved for most of the industry; however, the ability to cover long-term obligations remained a serious concern for over a quarter of Massachusetts hospitals.

About this Report

The Division of Health Care Finance and Policy (the Division) publishes quarterly acute hospital financial reports in response to a legislative mandate to provide an annual assessment of financial trends in the acute care hospital industry. Quarterly reporting is one part of the Division's ongoing program to better protect the public interest by continuously monitoring the financial condition of acute care hospitals. This report presents an industry-wide analysis of FY04 hospital financial data that has been reconciled to the hospital's audited financial statements, and supersedes the Division's Quarterly Acute Hospital Financial Report for FY04 Q4 published in March 2005.[1] On an aggregate basis, the findings have changed minimally compared to the FY04 Q4 report; however, individual hospital values may have changed significantly as a result of the audit process and year-end adjustments. Financial trends for individual hospitals are on each hospital's Fact Sheet in the DHCFP Data Catalog at www.mass.gov/dhcfp.

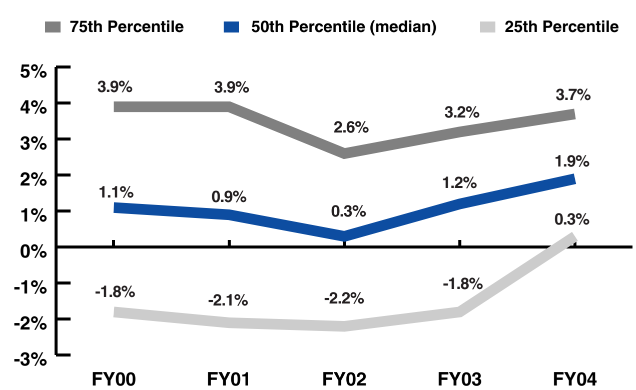
Trends in financial ratio analysis can provide useful information about the hospital industry's financial condition. The three areas examined on a quarterly basis and discussed in this report are profitability, liquidity, and solvency.[2]

Profitability

Although most Massachusetts acute care hospitals are non-profit, they do need to generate a sufficient surplus in order to complete their missions, repay debt, and invest in the future of their organizations. Therefore, an analysis of the industry's profitability using three key ratios is reported here. Figures 1, 2, and 3 show FY00-FY04 trends for 25th, 50th (median) and 75th quartile values[3] for Total Margin,[4] Operating Margin,[5] and Non-operating Margin.[6]

The industry showed improvement in overall profitability in FY04 (see Figure 1). Median Total Margin increased to 1.9% in FY04, up from 1.2% in FY03. For the first time in over five years the lower quartile experienced a positive Total Margin (0.3%), compared to a 1.8% total loss in FY03. How-

Figure 1
Total Margin Trend, FY00-FY04



- **All quartiles showed improvement in overall profitability and fewer hospitals experienced losses; however over one-fifth of hospitals experienced a total loss. Improved Total Margins were due to gains in both operating and non-operating performance.**

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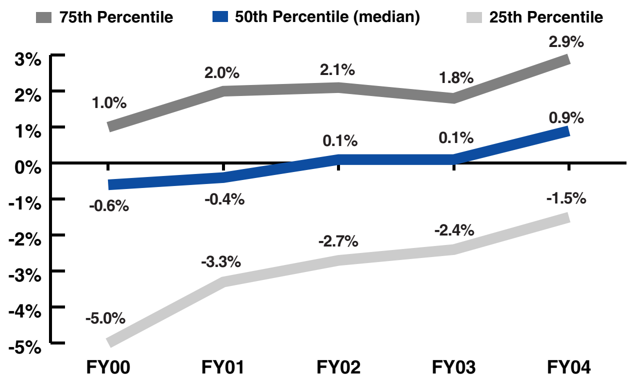
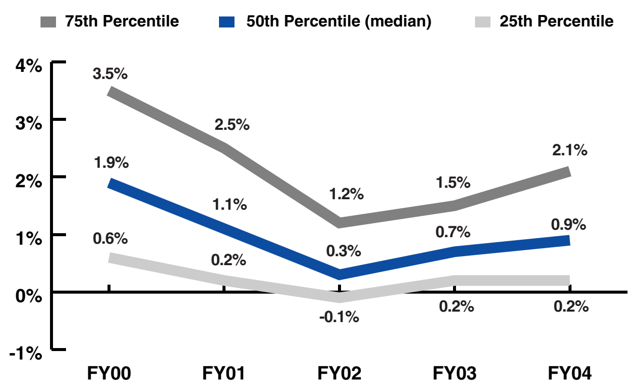
Figure 2
Operating Margin Trend, FY00-FY04



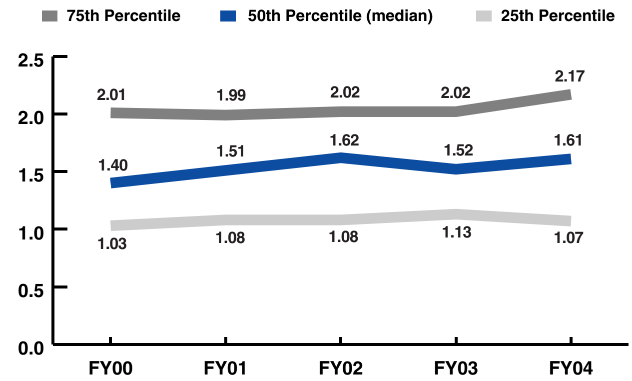
- **Operating performance improved across the industry, and although fewer hospitals had negative Operating Margins in FY04, 42% of the industry continued to operate at a loss.**

Figure 3
Non-operating Margin Trend, FY00-FY04



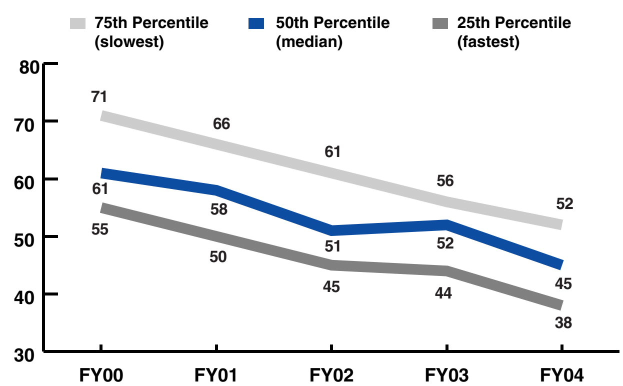
- **Fueled by improved market conditions, Non-operating Margins improved across all quartiles. Only 12% of the industry reported non-operating losses in FY04.**

Figure 4
Current Ratio Trend, FY00-FY04



- **Current Ratio improved for most of the industry; however, the lower quartile hospitals experienced a slight decline in liquidity. A majority of hospitals (79%) maintained Current Ratios above the 1.0 benchmark in FY04.**

Figure 5
Days in Accounts Receivable Trend, FY00-FY04



- **Continuing the industry's positive trend since FY00, hospitals managed collection of receivables more efficiently compared to FY03. Median Days in A/R was down by seven days in FY04.**

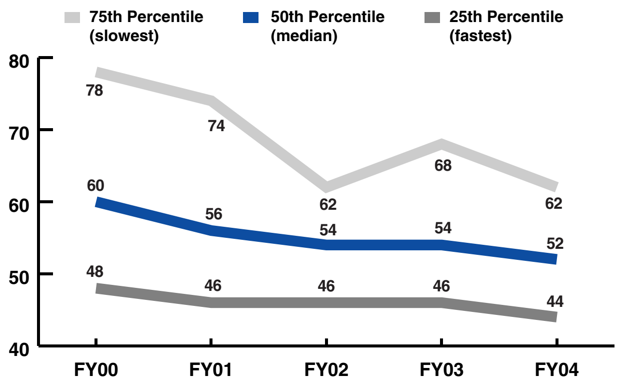
ever, more than a fifth of hospitals continued to experience total losses. Operating performance also improved, reaching a five-year high for all quartiles in FY04 (see Figure 2); nevertheless, 42% of hospitals continued to operate at a loss. Non-operating gains increased across all quartiles (see Figure 3), enhancing overall profitability for all but eight hospitals reporting non-operating losses.

Liquidity

Liquidity ratios indicate a hospital's ability to meet its short-term obligations. Deterioration of these ratios is one indication of financial stress. Three liquidity ratios are reported here: Current Ratio,[7] Average Days in Accounts Receivable (A/R),[8] and Average Payment Period.[9] Figures 4, 5, and 6 show trends in quartile values for these three ratios.

Figure 6

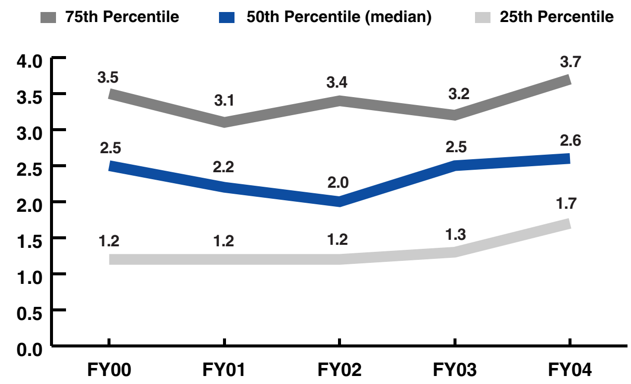
Average Payment Period Trend in Days, FY00-FY04



- **Average Payment Period improved across all quartiles in FY04; however, nearly a third of hospitals paid current obligations at a faster rate than they collected receivables.**

Figure 7

Debt Service Coverage Total Trend, FY00-FY04



- **Debt Service Coverage improved across all quartiles. The lower quartile was above the benchmark of 1.5, a first in five years for the industry; however, nearly 20% of the industry may face difficulty covering interest and principal payments in FY05.**

The majority of hospitals demonstrated more favorable short-term liquidity and a stronger ability to meet current obligations. Current Ratio improved for most of the industry, with a majority of hospitals (79%) performing above the 1.0 minimum benchmark in FY04 (see Figure 4).[10] On a less positive note, the lower quartile hospitals showed a slight decline in Current Ratio compared to FY03. The majority of hospitals in the lower quartile for Current Ratio also exhibited near zero or negative total margins in FY04.

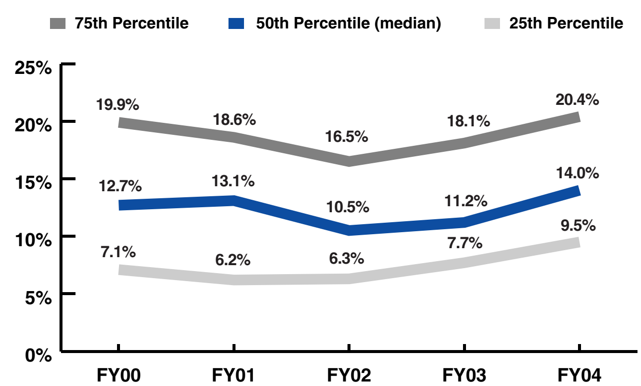
Overall, the industry showed more efficient management of Days in A/R (see Figure 5) and improved average time to pay current liabilities (Average Payment Period, see Figure 6) across all quartiles. Nearly a third of hospitals, however, are paying current obligations at a faster rate than they are collecting payments. This could lead to cash flow constraints for this group in the future.

Solvency

Solvency ratios provide information regarding both how an organization finances its assets and how able an organization is to take on new debt. Deterioration of these ratios is another indication of problems in the financial health of an organization. Three solvency ratios are reported here: Debt Service Coverage[11], Cash Flow to Total Debt[12], and Equity Financing.[13] Figures 7, 8, and 9 show trends in quartile values for these three ratios.

Figure 8

Cash Flow to Total Debt Trend, FY00-FY04



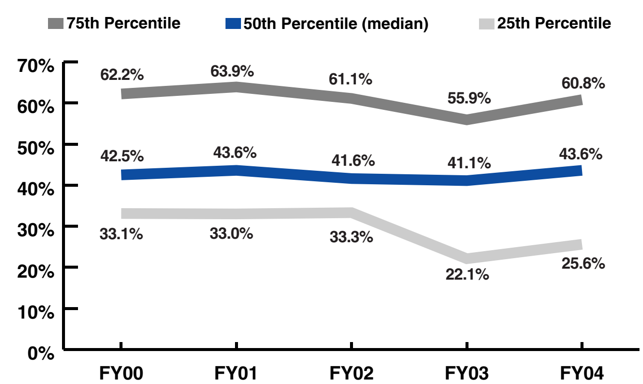
- **Cash Flow to Total Debt improved substantially over FY03. Improvements were largely due to enhanced profitability for the industry.**

Debt Service Coverage, which measures the ability to meet principal and interest payments in the upcoming year, improved for the majority of the industry in FY04. Median Debt Service Coverage remained above the 1.5 benchmark, and the lower and upper quartile hospitals significantly improved (see Figure 7). The lower quartile reached an above benchmark level of 1.7 for Debt Service Coverage, a first in five years for the industry. It is important to note, however, that nearly a fifth of hospitals had Debt Service Coverage below the 1.5 benchmark; these hospitals may experience difficulty in meeting interest and principal debt payments in FY05.

Cash Flow to Total Debt, a measure of a hospital's percentage of cash flow to current and long term debt obligations and a known indicator of future financial distress and insolvency, improved over FY03 (see Figure 8). More than half of the industry showed increased Cash Flow to Total Debt ratios, and all quartiles improved over the previous year. Improvements were largely attributable to enhanced overall profitability for the industry.

The Equity Financing ratio, measured by the proportion of total assets financed by equity, reflects the ability of a hospital to take on more debt. Low values indicate that a hospital is highly leveraged, and therefore may have difficulty securing access to debt financing for further asset acquisition.

Figure 9
Equity Financing Trend, FY00-FY04



- **Equity Financing Ratios improved slightly for most of the industry in FY04; however, over a quarter of hospitals were below the 30% benchmark. The highly leveraged position of some hospitals may make future asset acquisition difficult for this group.**

Equity Financing improved for the majority of hospitals in FY04 compared to FY03; however this ratio was below the 30% industry benchmark for more than a quarter of the hospitals, indicating long-term solvency issues for this group.

Teaching versus Non-teaching Hospitals

The Division also examines the financial health of teaching and non-teaching hospitals using financial ratio analysis. In terms of profitability, teaching hospitals outperformed non-teaching hospitals. A lower percentage of teaching hospitals experienced overall losses compared to non-teaching hospitals. In addition, all teaching hospitals showed non-operating gains, while eight non-teaching hospitals experienced non-operating losses . Non-teaching hospitals, however, showed some improvement over the previous year; only 24% experienced negative Total Margins compared to nearly 40% the previous year.

Teaching hospitals exhibited a slightly stronger liquidity position compared to non-teaching hospitals. On average, Current Ratio was higher for teaching hospitals; but a higher percentage (33%) of teaching hospitals had Current Ratios below the minimum industry benchmark of 1.0 (compared to 18% of non-teaching hospitals). Both teaching and non-teaching hospitals exhibited comparable improvement in collecting receivables due and paying current obligations.

Non-teaching hospitals may have more difficulty meeting interest and principal payments in FY05 since more than 20% of these hospitals were below the 1.5 benchmark for Debt Service Coverage in FY04. In addition, non-teaching hospitals were more leveraged than teaching hospitals overall. Interestingly, however, non-teaching hospitals showed greater improvement in Equity Financing over FY03 compared to teaching hospitals.

Summary

The majority of hospitals reported improved overall profitability in FY04; however over a fifth of hospitals continued to experience a total loss. Increases in overall profitability were largely attributable to an increased focus on operating activities and improved investment market conditions. Only 12% of acute care hospitals reported non-operating losses, all of which were non-teaching. Liquidity improved compared to FY03, and a majority of hospitals demonstrated stronger ability to meet current obligations. Improved liquidity was likely aided by both improved profitability and improved collections of receivables. In addition, most hospitals appear able to meet the upcoming year's interest and principal debt payments. For a quarter of the industry, long-term solvency remains a serious matter. Although Equity Financing improved for a majority of the industry, the highly leveraged positions of the least solvent hospitals indicate that these hospitals are likely to have difficulty financing future asset acquisition.

Financial ratio values for each hospital are on the Hospital Fact Sheets in the Division of Health Care Finance and Policy Data Catalog at www.mass.gov/dhcfp. Hospital-specific dollar surplus or loss, net patient service revenue, total net assets, and assets whose use is limited are also provided on the Hospital Fact Sheets illustrating the magnitude of hospital surplus and loss, the size of operation, and the size of reserves.

[1] The findings in this report are based on the year-end financial filings of 66 acute care hospitals. For 61 of the reporting hospitals, the financial filings are based on 12 months of audited financial data which has been reviewed by the Division. Three hospitals (Mercy, MetroWest, and St. Vincent) have a fiscal year that ends on December 31, thus their filings represent 12 months of unaudited data. Two hospitals (Hubbard Regional and Nantucket Cottage) audited filings were unavailable, thus their filings represent 12 months of unaudited data. Salem and Union hospitals are no longer reported individually since North Shore Medical Center now includes both Salem and Union Hospital information.

[2] Depending on the organization of each hospital, data may exclude other aspects of some hospitals' financial health, such as performance of endowments or the financial health of parent or other affiliated organizations.

[3] Quartile values can shed light on information about the distribution of financial ratio values across hospitals. Often, averages can be materially affected by outlier/extreme values at the low and high ends of a distribution. Examining quartiles, therefore, is a preferred means of assessing the overall distribution of values across hospitals. For instance, the ratio values of one quarter of the hospitals at the low end of the distribution will fall at or below the 25th quartile value. Similarly, the ratio values of one quarter of the hospitals at the high end of the distribution will fall at or above the 75th quartile value. The 50th percentile is the median, or the center of the distribution of values. Half of the hospitals' financial ratio values will fall below the median, and half will fall above the median. These quartile measures are particularly useful when a distribution is markedly skewed, or where it is generally symmetrical but includes a few outliers.

[4] Ratio of total income to total revenue.

[5] Ratio of operating income to total revenue.

[6] Ratio of non-operating income to total revenue.

[7] Ratio of current assets to current liabilities.

[8] Ratio of net patient accounts receivable to net patient service revenue/quarters of data * 91.25.

[9] Ratio of current liabilities less estimated third-party settlements to total expenses less depreciation and amortization/quarters of data * 91.25.

[10] A Current Ratio value of 1.0 indicates that a hospital has one dollar held in current assets per dollar of current liabilities. Values below 1.0 are considered strongly unfavorable and highlight an organization's illiquid position.

[11] Ratio of total income plus interest expense plus depreciation and amortization to interest expense plus current portion of long-term debt.

[12] Ratio of total income plus depreciation and amortization to total current liabilities plus total long-term debt.

[13] Ratio of total net assets to total assets.

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